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EARLY DISTRIBUTIONS FROM RETIREMENT PLANS

WASHINGTON -- An early distribution from an Individual Retirement Account (IRA) or a qualified retirement plan need not be a “taxing” experience, according to the IRS.

A lump sum of funds that you receive from your IRA or qualified retirement plan before you reach age 59½ is normally called an “early” or “premature” distribution. As such, these funds are subject to an additional 10 percent tax. But there are a number of exceptions to the age 59½ rule that you should investigate if you make such a withdrawal. Some of these exceptions apply only to IRAs, some only to qualified retirement plans, and some to both.

In addition to the 10 percent tax on early distributions noted above, the employer’s contribution and any income earned on contributions you made are taxable. You may keep an amount equal to your nondeductible contribution tax-free. Also, you may be entitled to special tax treatment for the remainder of the distribution.

There is a way to avoid paying tax on early distributions, however. It is called a “rollover”. Generally, a rollover is a tax-free transfer of cash or other assets from an IRA or qualified retirement plan to an eligible retirement plan. An eligible retirement plan is a traditional IRA, a qualified retirement plan, or a qualified annuity plan. You must complete the rollover within 60 days of when you received the distribution. The amount you roll over tax free is generally taxable later when the new plan pays you or your beneficiary.

If the early distribution from an employer’s plan is paid directly to you, your plan administrator will normally withhold income tax at a 20 percent rate. If you roll over the distribution to a new plan, you must replace that 20 percent of the funds that were withheld and deposit that amount in the new plan, or you will owe tax on that amount. To avoid this inconvenience, you can choose to have your old plan’s administrator transfer the distribution directly to the new plan or a traditional IRA.

All early distributions must be reported to IRS. Tax-free rollovers may be reported on lines 15a and 16a of Form 1040 along with taxable distributions. The 10 percent tax or exceptions must be figured on Form 5329 and then carried to line 54 on Form 1040. Rollovers may also be reported on Form 1040A, but any distributions to which the 10 percent tax applies must be reported on Form 1040.

Important tax information should be reported to you by your plan administrator on Form 1099-R. This will show the distribution amount, the taxable portion, any tax withheld, and a distribution code related to the 10 percent tax. If your early distribution is subject to the 10 percent tax and distribution code 1 is correctly shown in box 7 of your Form 1099-R, you do not have to complete Form 5329. Just enter 10 percent of the taxable distribution amount on line 54 of Form 1040.

For more information, see Publication 575, "Pension and Annuity Income." This publication and the forms and instructions can be downloaded from the "Forms & Pubs" section of the IRS Web site at www.irs.gov. You may also call 1-800-829-3676 to order them.